

# Employee Plans Compliance Resolution System (EPCRS)-

## Revenue Procedure 2006-27

# Agenda

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- EPCRS overview
- Review of significant changes in Rev. Proc. 2006-27
- Question and answer – anytime during the presentation

# EPCRS Current Programs

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- Revenue Procedure 2003-44 was the current applicable document for EPCRS until Rev. Proc. 2006-27 was released on May 5, 2006. Rev. Proc. 2006-27 is generally effective on September 1, 2006. Can elect rev. proc. provisions as early as May 30, 2006.
- Revenue Procedure 2006-27 contains three correction programs (the same programs as found in Rev. Proc. 2003-44)
  - Self Correction Program (SCP)
  - Voluntary Correction Program (VCP)
  - Audit Closing Agreement Program (Audit CAP)

# Type of Plans Covered

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- Qualified Plans under IRC § 401(a)
- 403(b) Plans
- SEP and SARSEPs under IRC § 408(k)
- Simple IRAs under IRC § 408(p)
- Eligible 457(b) Plans
  - Issues can be resolved pursuant to a closing agreement

# Qualification Failures

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## ■ Plan Document Failure

- Plan provision (or absence of provision) that violates § 401(a). Includes the failure to adopt good faith or interim amendments with respect to disqualifying provisions.

## ■ Operational Failure

- Plan document complies with § 401(a) but plan doesn't operate in accordance with its provisions.

# Qualification Failures, (con't)

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## ■ Demographic Failures

### ■ Failure to satisfy:

- Minimum participation requirements of § 401(a)(26)
- Coverage requirements of § 410(b)
- Nondiscrimination requirements of § 401(a)(4)

## ■ Employer Eligibility Failure

- Employer was not eligible to adopt plan, e.g. state/local government adopts 401(k) plan

# What Can be Accomplished?

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- For qualified plans
  - Continued qualification of the plan under IRC § 401(a)
- For 403(b) plans
  - Avoid income inclusion for participants and income tax withholding liability
- For SEPs and Simple IRAs
  - Continued compliance with IRC § 408(k) or 408(p), as applicable

# Overview:

## Changes to Rev. Proc. 2003-44

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- Plan loans
- Defaulted loans
- Requests for Determination Letters
- ATATs (Abusive Tax Avoidance Transactions)
- Excise taxes
- Orphan plans
- Failure to obtain spousal consent
- Failure to include eligible employee
- Fees
- Miscellaneous changes
- Effective Date



# Changes Related to Plan Loans

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- Under VCP, Service will allow correction where plan loans did not comply with:
  - Limit on loans pursuant to IRC § 72(p)(2)(A)
  - Plan term requirements of IRC § 72(p)(2)(B)
  - Where loans were defaulted and not reported, but the repayment period has not expired

# Plan Loan Example -72(p)(2)(A)

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## ■ Example:

- Participant borrows \$60K
- Two years later, violation discovered

## ■ Correction:

- Participant repays \$10K
- Remaining loan balance reamortized over remaining life of the original loan
- Prior loan payments attributable to \$10K excess can be (1) applied to interest on excess so participant only repays \$10k or (2) can be applied to the remaining loan balance and the participant repays \$10k (including interest)

# Plan Loan Example -72(p)(2)(B)

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- Example:
  - Participant borrows \$10K over six year period (should have been 5 years)
  - Two years later, violation discovered
- Correction:
  - Loan is reamortized over the remaining 3-year period of the loan
- Note: Correction not available where statutory term of loan has expired

# Plan Loan Example –Defaulted Loans

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- Example:
  - Participant borrows \$10K over 5 year period
  - Loan Payments never begin
  - Two years later, violation discovered
- Correction:
  - Option 1 – Participant makes lump sum payment (plus, interest) to bring loan current, and continues payments under old payment schedule
  - Option 2 – Loan is reamortized over the remaining life of the original loan term
  - Option 3 – Any combination of Option 1 or Option 2.
- Correction Principle:
  - Employer may be required to pay a portion of the correction payment on behalf of the participant equal to the additional interest owed by the participant for failure to timely repay the loan if the employer is partially at fault for not beginning repayment of loan

# Submission for a Determination Letter under SCP

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- In the case of any correction of an operational failure through plan amendment under SCP, a plan sponsor must submit for a determination letter
- Failure to provide for loans in plan document can now be fixed under SCP
- The determination letter application must be submitted before the end of the plan's applicable remedial amendment cycle described in Revenue Procedure 2005-66

# Submission for a Determination Letter under VCP and Audit CAP

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- For a nonamender failure (other than through the adoption of a model amendment or the adoption of a prototype or volume submitter plan), a determination letter must be submitted using the appropriate Form 5300 series application form
- The term “nonamender” means a failure to amend the plan to reflect a change in a qualification requirement within the plan’s applicable remedial amendment period (or cycle)

# Submission for a Determination Letter under VCP and Audit CAP (con't)

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- A determination letter may be issued for a failure that is being corrected in a VCP filing for a terminating plan or a terminating plan under examination
- A determination letter may be issued to correct a failure in a plan submitted under VCP or that is being examined during the last 12 months of the plan's remedial amendment cycle as defined in Rev. Proc. 2005-66 (an "on-cycle" plan)
- In cases where a determination letter is not issued with respect to failures corrected through plan amendment, the issuance of a compliance statement or closing agreement will constitute a determination as to the effect of any plan amendment on the qualification of the plan except for (1) good faith EGTRRA amendments, (2) amendments for the final and temporary 401(a)(9) regulations and (3) interim amendments

# Submission for a Determination Letter under VCP and Audit CAP (con't)

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- A determination letter will not be issued for plan amendments adopted to correct a failure to amend the plan timely for (1) good faith EGTRRA amendments, (2) plan amendments for the final and temporary regulations under §401(a)(9), or (3) interim amendments unless (a) the failure is submitted in a VCP filing for an on-cycle year or for a terminating plan, or (b) the plan is being examined for an on-cycle year or is a terminating plan under examination



# ATAT (Abusive Tax Avoidance Transaction)- Definition for SCP & VCP

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- An abusive tax avoidance transaction (ATAT) means any listed transaction under § 1.6011-4(b)(2) and any other transaction identified as an abusive transaction in the IRS web site entitled "EP Abusive Tax Transactions"

# ATATs – SCP

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- Under SCP, if the plan or the Plan Sponsor has been a party to an abusive tax avoidance transaction, SCP is not available to correct any Operational Failure that is directly or indirectly related to the abusive tax avoidance transaction

# ATATs – VCP

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- Under VCP, if the Service determines that a plan or plan sponsor was, or may have been, a party to an abusive tax avoidance transaction, the matter will be referred to the Internal Revenue Service's Employee Plans' Tax Shelter Coordinator
- If the Service determines that the plan or the Plan Sponsor has been a party to an abusive tax avoidance transaction, and that the failures in the VCP submission are related to the ATAT, the case will be referred to EP Exam
- if the Service determines that the plan failures are unrelated to the ATAT or that no ATAT occurred, a compliance statement can be issued

# ATATs – Audit CAP and SCP (while Under Examination)

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- If the Service determines that the plan or Plan Sponsor was, or may have been, a party to an abusive tax avoidance transaction, the matter may be referred to the Internal Revenue Service's Employee Plans' Tax Shelter Coordinator
- if the Service determines that a failure is related to the abusive tax avoidance transaction, the Service reserves the right to conclude that neither Audit CAP nor SCP (for operational failures discovered Under Examination) is available for that failure
- If the Service determines that satisfactory corrective actions have not been taken with regard to the transaction, the Service reserves the right to conclude that neither Audit CAP nor SCP (for operational failures discovered Under Examination) is available to the plan
- Definition of ATAT expanded to include any transaction designed to facilitate the impermissible avoidance of tax

# Changes Related to Excise Taxes

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- Under VCP, relief from excise taxes of § 4972 where plan sponsor is required to make a contribution as part of correction
  - Relief from the excise tax must be requested in the VCP submission
- Under VCP, relief from excise taxes pursuant to § 4979, in limited instances; e.g., where testing was timely and inaccurate data resulted in underpayment of excess contributions or excess aggregate contributions

# Changes Related to Orphan Plans

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- EPCRS is now available for Orphan Plans
- Available under VCP or Audit CAP
- VCP Application made by “Eligible Party” where it has been determined that plan sponsor:
  - No longer exists
  - Cannot be located
  - Is unable to maintain the plan, or
  - Has abandoned the plan pursuant to DOL regulations

# Changes Related to Orphan Plans, (con't)

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- “Eligible Party” is a person or entity that is eligible to complete the functions to terminate the plan and distribute plan assets
- Persons or entities include:
  - Court appointed representatives
  - In the case of an Orphan Plan under DOL investigation, the person or entity who DOL has determined has accepted responsibility for terminating the plan and distributing assets
  - Surviving spouses of plans never covered by Title I of ERISA where participant was sole owner of business and only participant in plan

## Changes Related to Orphan Plans, (con't).

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- Service retains right under VCP or Audit CAP not to require full correction for orphan plans
- Service may waive VCP fees in the case of a terminating orphan plan



# Changes Related to Failure to Obtain Spousal Consent

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- Rev. Proc. 2003-44 provided that if spousal consent cannot be obtained, spouse is entitled to a benefit equal to the portion of QJSA that would have been payable to spouse under the plan at the annuity starting date of the prior distribution

# Changes Related to Failure to Obtain Spousal Consent, (con't)

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- This correction continues in Rev. Proc. 2006-27
- Adds new alternative that permits correction by a lump sum distribution to the spouse equal to the present value of the annuity determined under the old correction method
- Interest and mortality factors in § 417(e)(3) used to calculate lump sum

# Changes Related to Failure to Include Eligible Employee in 401(k) Plan

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- Old correction in Rev. Proc. 2003-44 for excluding an otherwise eligible employee under a 401(k) plan is:
  - A QNEC equal to the ADP for the class of employee (NHCE or HCE) that was excluded times the employee's compensation, and
  - A QNEC equal to the ACP for the class of employee (NHCE or HCE) that was excluded times the employee's compensation

# Failure to Include in 401(k) Non Safe Harbor Plan

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- New correction in Rev. Proc. 2006-27 is based on the lost opportunity cost to make deferrals
- For salary deferrals, the opportunity cost is 50% of the pre-tax deferrals the employee would have made if included timely in the plan
- Like the old method, the amount of deferrals is based upon the employee's compensation times the ADP of the employee's class (NHCE or HCE)
- This correction method can be used for a failure (1) to include an otherwise eligible employee in a 401(k) plan for an entire year or (2) to include a participant for part of the year

# Failure to Include in 401(k) Non Safe Harbor Plan (con't)

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- The matching contribution for the excluded employee will be equal to the matching contributions that would have been received if the employee had made pre-tax deferrals
- The matching contribution is based on the full amount of deferrals, not the lost opportunity cost of making the deferrals (i.e., not 50% of the QNEC)
- This is different from the Rev. Proc. 2003-44 where matching contribution would have been equal to the employee's compensation multiplied by the applicable ACP

# Example 1: Failure to Include in 401(k) Non Safe Harbor Plan

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## ■ Example:

- NHCE has compensation of \$30K and incorrectly excluded from plan
- Plan provides match equal to 100% of first 3% of compensation
- NHCE ADP = 4%

## ■ Correction:

- QNEC for lost opportunity cost is \$600 (\$30K times 4% times 50%)
- QNEC for matching contribution is \$900 (\$30K times 3%)

# Failure to Include in Safe Harbor 401(k) Plans

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- For plans that use a 3% non-elective contribution, the missed deferral is deemed to be 3% of compensation
- The QNEC for the missed opportunity cost of making a pre-tax deferral is 50% of 3% of compensation
- If the 3% safe harbor contribution was not made to the employee, an additional QNEC of 3% must also be made

# Example 2: Failure to Include in Safe Harbor 401(k) Plans

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- Example:
  - NHCE has compensation of \$30K and incorrectly excluded from plan
- Correction:
  - QNEC for missed opportunity cost of salary deferral is \$450 ( $\$30K \times 3\% \times 50\%$ )
  - If applicable, QNEC for safe harbor contribution is \$900 ( $\$30K \times 3\%$ )



# Failure to Include in Safe Harbor 401(k) Plans, (con't)

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- For plans that use a matching contribution of 100% of the first 3% of compensation and 50% of the next 2% of compensation, the missed deferral is deemed to be the greater of:
  - 3% of compensation, or
  - The maximum deferral percentage for which the employer provided a matching contribution rate that is as least as favorable as 100% of the elective deferrals made by the employee

## Failure to Include in Safe Harbor 401(k) Plans, (con't)

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- The QNEC for the matching contribution is equal to the matching contribution that would have been received if the employee had made the deemed pre-tax deferrals

# Example 3: Failure to Include in Safe Harbor 401(k) Plans

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## ■ Example:

- NHCE has compensation of \$30K and is incorrectly excluded from plan
- Plan provides match equal to 100% of first 3% of compensation and 50% of the next 2% of compensation

## ■ Correction:

- QNEC for missed opportunity cost of deferral is \$450 ( $\$30K \times 3\% \times 50\%$ )
- QNEC for matching contribution is \$900 ( $\$30K \times 3\%$  of compensation)

# Example 4: Failure to Include in Safe Harbor 401(k) Plans

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## ■ Example:

- NHCE has compensation of \$30K and is incorrectly excluded from plan
- Plan provides match equal to 100% of deferrals up to 4% of compensation

## ■ Correction:

- QNEC for missed opportunity cost of deferral is \$600 (\$30K times 4% times 50%)
- QNEC for matching contribution is \$1,200 (\$30K times 4% of compensation)

# Failure to Include in Plan with After-Tax Contributions

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- Correction is based on the lost opportunity cost to make after-tax contributions
- For after-tax contributions, the opportunity cost is 40% of the after-tax contributions the employee would have made if included timely in the plan
- The amount of after-tax contributions is based upon the employee's compensation times the ACP of the employee's class (NHCE or HCE)
- Alternately, the employer can separately determine the ACP attributable to after-tax contributions, and use that percentage to determine the missed after-tax contributions

# Changes Related to Fees

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- For VCP submissions involving the failure to make required minimum distributions, a reduced fee of \$500 will apply where the number of affected participants is 50 or less
- Compliance fee for a SEP or Simple IRA Plan is reduced to \$250 from \$500 (most cases)
- Fee for failure to amend for EGTRRA good faith, 401(a)(9) and interim amendments-flat \$375 fee

# Changes Related to Fees, cont.

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- A new fee schedule will apply to nonamender issues discovered by the Service during the determination letter process
- The fee will be based upon the number of participants in the plan and the legislation for which the plan is not amended

# Miscellaneous Changes

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- A sample "Acknowledgement Letter" has been added as Appendix E
- A section on "Assembling the Submission" has been added to expedite processing (revised Appendix D)
- Added a streamlined submission package for interim nonamender failures (new Appendix F)



# Miscellaneous Changes, (con't)

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- Group Submission procedures have been clarified to provide that each M&P plan of a sponsor is considered a separate submission
- Under VCP or Audit CAP, if Excess Amount attributable to participant or beneficiary is \$100 or less, such amount is not required to be distributed or forfeited.
  - If excess amount is the result of exceeding statutory limit, employee must be notified that excess amount not eligible for rollover

# Miscellaneous Changes, (con't)

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- Under VCP and Audit CAP for Overpayments of \$100 or less, the plan sponsor is not required to notify the participant or beneficiary that the Overpayment is not eligible for rollover
- Factor added for Audit CAP relating to nonamenders discovered during EP examination – Sanction will be greater than sanction for failure discovered during determination letter process

# Request for Comments

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- As part of Rev. Proc. 2006-27, the Service has requested comments on how to correct certain failures under EPCRS
  - 414(v) Catch-up Contributions
  - Designated Roth Contributions in 401(k) and 403(b) Plans
  - Applicable correction methods for 415 failures once dropped from 415 regulations
  - whether additional correction methods are needed in order for plans to take advantage of the fiduciary safe harbor recently issued by DOL

# Effective Date – Rev. Proc. 2006-27

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- General Effective Date is September 1, 2006
- Section 11.11 (Acknowledgement Letter), Section 11.14 (Assembling the Submission) and Section 14.04 (Fees for Nonamenders discovered during DL process) and effective May 30, 2006
- Plan sponsors are permitted to apply the provisions of the new rev. proc. as of May 30, 2006